FINAL TANGIBLE PROPERTY REPAIR REGULATIONS ISSUED

Taxpayers are generally permitted to deduct their business expenses, including repairs and maintenance, and are required to capitalize and depreciate costs incurred to acquire, produce, or improve tangible property. The IRS and Treasury Department recently released the long-awaited final regulations which provide a framework for distinguishing repairs and maintenance from capital expenditures and revamped proposed regulations regarding partial asset dispositions. This tax alert provides an overview of the key provisions in the recently-issued regulations.

Amounts Paid to Improve Property

Under the final regulations, the cost associated with a betterment, restoration, or adaptation of property is generally required to be capitalized.

- A betterment corrects a defect that existed at the time the property was acquired, results in a material addition to the property, or results in a material increase in capacity, productivity, efficiency, strength, or quality of the property. For example, significant repair work performed on a property shortly after the property's purchase appears to constitute a betterment.
- A restoration includes returning property to normal operating condition from a state of nonfunctional disrepair, rebuilding property to like-new condition at the end of the property's useful life, and replacement of a major component or structural part of property. For example, replacement of a roof and rafters at the end of the roof's life appears to constitute a restoration.
- An adaptation is a change to the property which allows the property to serve a new or different use that is inconsistent with the originally intended use of the property. For example, conversion of a manufacturing facility into a showroom appears to constitute an adaptation.

The IRS has provided a safe harbor whereby it will not challenge a taxpayer's deduction of routine maintenance costs as long as the maintenance costs are expected to be incurred at least twice during the property's useful life. For this purpose, the useful life of a building is considered to be 10 years, significantly reducing the usefulness of the rule in the context of building maintenance.

Taxpayers can make an annual election immediately to write off a capital expenditure associated with a building if the following requirements are met: (i) the taxpayer has less than $10 million of revenue, (ii) the initial cost of the building is $1 million or less, and (iii) the amount paid for repairs, maintenance, and improvements (including those not required to be capitalized under the taxpayer's capitalization policy) during the year does not exceed the lesser of (a) $10,000 or (b) 2 percent of the original cost of the building.

The application of these rules is fact specific. Please consult with a GALLINA tax professional to understand whether there is an opportunity to immediately expense any significant repair or maintenance costs that you incur or expect to incur in the near future.

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De Minimis Rule for Capital Expenditures

Many taxpayers have a policy for financial statement purposes to write off capital expenditures below a specified threshold since tracking small capital expenditures is burdensome and generally does not have a material impact on their net income. While courts have, in certain instances, allowed taxpayers to follow their book capitalization policy for tax purposes, there is risk that the IRS would disagree with the capitalization policy. The final regulations provide a safe harbor whereby the IRS will not challenge a taxpayer's capitalization policy as long as the following requirements are met: (i) the taxpayer has, and consistently follows, a written capitalization policy in which the capitalization threshold does not exceed $5,000, (ii) the taxpayer has audited financial statements, and (iii) the taxpayer makes an annual election to adopt the safe harbor. If the taxpayer is otherwise eligible for the safe harbor but does not have audited financial statements, then the safe harbor is available only if the capitalization threshold does not exceed $500.

While taxpayers may be able to continue using their historic capitalization policy even if that policy does not qualify for the safe harbor, taxpayers should consider establishing a written capitalization policy or modifying their existing policy to conform to the IRS safe harbor if feasible.

Partial Dispositions of Property

Under the proposed regulations, taxpayers can choose to recognize gain or loss on a partial disposition of an asset. An example of a partial disposition would be a replacement of a roof, which constitutes only part of the overall building structure. Under prior law, taxpayers would be required to capitalize the costs of the roof replacement but would not be entitled to deduct the loss resulting from the removal of the old roof since the building has not been disposed. Under the proposed regulations, a taxpayer can choose to deduct a loss associated with a roof replacement. While it may be difficult to quantify the amount of the loss in most situations (for example, how much of the purchase price of a building is attributable to the roof?), the tax benefit will justify the effort in situations where the cost attributable to the disposed component is significant.

Materials and Supplies

In general, taxpayers are allowed to deduct materials and supplies used in their business as the materials and supplies are used (rather than the year in which the materials and supplies are purchased). The final regulations provide taxpayers some relief by allowing taxpayers to expense property that has an acquisition or production cost of $200 or less. While the materials and supplies rules require taxpayers to capitalize materials and supplies with an acquisition cost greater than $200, taxpayers can expense amounts in excess of the $200 in accordance with their written capitalization policy.

Effective Date

The final regulations are effective for tax years beginning on or after January 1, 2014. For tax years beginning in 2012 or 2013, taxpayers can choose to (i) continue to use their established methods of accounting, (ii) early adopt the final regulations, or (iii) early adopt the 2011 temporary regulations.

Consult with a GALLINA tax professional to make sure that you're using the most favorable set of rules available to you.

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